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CECL Financial Statement Disclosures — What's Changing?

The overarching purpose of the Financial Accounting Standards Board (FASB) financial statement disclosures is to provide investors with insights into the risks of each institution, to be read in conjunction with the financial statements and investment schedules provided. When the financial crisis occurred, there were many surprises for investors, specifically in the area of financial instrument credit risk. The Current Expected Credit Losses (CECL) standard (ASC 326), which will be effective January 1, 2020, for first-wave (calendar year) SEC filers,[1] was designed to provide greater transparency and understanding of credit risk by incorporating estimated, forward-looking data when measuring lifetime Estimated Credit Losses (ECL) and requires enhanced financial statement disclosures.

The magnitude of change driven by the enhanced financial statement disclosures requirements under CECL is significant in terms of the need for additional data; changes to systems, policy and process; and expansion of management's presentation and analysis that must be prepared by institutions.

It is expected that these changes will result in investors and other financial statement users having a better overall understanding of credit risk within loan and investment portfolios, as well as more transparency into an organization's risk management practices, loss methodology and key modeling assumptions, and drivers of change in the resulting loss estimates for each financial reporting period. One of the key enhancements regarding CECL is a required articulation of information in the financial statement disclosures not only to allow investors to better understand management's estimate of lifetime credit loss but also to enhance their own alternative estimates to better evaluate the magnitude of impact using different assumptions from those provided by management.

Analysis of Disclosure Impact

While some of the disclosure changes under CECL are significant and mandate new presentation, such as the amortized cost of financial assets by origination year (vintage), others require more qualitative changes explaining the inputs used to estimate credit losses and greater detail regarding off-balance sheet credit exposures. Many legacy disclosures were retained with minor adjustments. Other legacy disclosures, such as the impaired loans disclosures, will be superseded, since the concept of impairment no longer exists under CECL.

[1] **CECL implementation dates are as follows:** public business entities (PBEs) that are SEC filers for fiscal years beginning after December 15, 2019, PBEs that are not SEC filers for fiscal years beginning after December 15, 2020, and all other entities for fiscal years beginning after December 15, 2021.

At a high level, the disclosure changes under CECL fall into three general categories:

- ECL estimate methodology and assumptions
- Quantitative information and metrics
- Policy and process explanations

Across these three broad categories, the required disclosures comprise a more prescriptive version of what is currently required in the financial statement footnotes and the Management Discussion and Analysis (MD&A) sections of periodic, public financial statement filings such as forms 10-K (annual) and 10-Q (quarterly).

Financial Instruments Measured at Amortized Cost

Discussed in the new CECL guidance, financial instruments measured at amortized cost include loans, net investments in leases and held-to-maturity securities. The subtopic ASC 326-20-50 includes guidance on required reporting of credit risk and expected credit loss measurement, as well as determining the appropriate level of detail to support disclosures. Below is a comparison of key topics under CECL versus legacy GAAP.

CREDIT QUALITY (BY VINTAGE)	
CECL Requirement	Requires disclosure of quantitative and qualitative credit quality information by class of financing receivable and major security type, which allows investors to understand how credit quality is monitored and assesses the quantitative and qualitative risks inherent in the credit quality of the assets, including: • Description of credit quality indicator(s) • Amortized cost basis by credit quality indicator • Date or date range of last assessment of the credit quality indicator Additionally, public business entities (PBE) are required to disclose the amortized cost basis by each credit quality indicator and by origination year for up to five (5) historical annual periods. For originations before the fifth annual period, entities may report at the aggregate level. Note that as of November 9, 2018, the FASB signaled support for an amendment that will require financial institutions to disclose charge-offs and recoveries by vintage year. This information is aligned with the spirit of the original 2016 guidance (and examples provided therein) in that this information is viewed as critical for investor understanding of underlying credit risk management practices and credit trends.
Legacy U.S. GAAP and Other Related Guidance	An entity is required to disclose financing receivable recorded investment by credit quality indicator.

PAST DUE	
CECL Requirement	Requires an aging analysis of the amortized cost basis by class of financing receivable and major security type for assets that are past due as of the reporting date, including explanation of the entity's definition of and criteria for determining past due status.
Legacy U.S. GAAP and Other Related Guidance	Current GAAP and other related guidance do not require entities to disclose policy for past due determination.

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<table>
<tr><th colspan="2">NONACCRUAL STATUS</th></tr>
<tr><td>CECL Requirement</td><td>By class of financing receivable and major security type, an entity must disclose four (4) balances and activity amounts for each period, including:
• Beginning and ending amortized cost basis balance of nonaccrual assets
• Interest income recognized during the period on nonaccrual assets
• Amortized cost basis balance for loans 90-plus days past due that are not on nonaccrual status
• Amortized cost basis balance for assets that are nonaccrual where no allowance for credit losses has been booked as of the current reporting period

ASC 326-20-50 also requires disclosure of an entity’s significant accounting policies related to non-accrual, including:
• Nonaccrual policies, including the policies for discontinuing/resuming accrual of interest, recording payments received on nonaccrual assets
• Policy for determining past due or delinquency status
• Policy for recognizing write-offs within the allowance for credit losses</td></tr>
<tr><td>Legacy U.S. GAAP and Other Related Guidance</td><td>Current U.S. GAAP and other related guidance are similar in nature to expected CECL reporting guidance.</td></tr>
<tr><th colspan="2">PURCHASED CREDIT DETERIORATED (PCD) ASSETS</th></tr>
<tr><td>CECL Requirement</td><td>If an entity has purchased assets with credit deterioration, it is required to provide a reconciliation of the difference between the purchase price and par value, including the allowance for credit losses at acquisition and discount or premium attributable to other factors.</td></tr>
<tr><td>Legacy U.S. GAAP and Other Related Guidance</td><td>Current U.S. GAAP and other related guidance do not require allowance booking at the time of purchase credit impaired (PCI) acquisition; therefore, no allowance for credit loss reporting exists.</td></tr>
<tr><th colspan="2">COLLATERAL DEPENDENT ASSETS</th></tr>
<tr><td>CECL Requirement</td><td>To the extent that repayment of the asset is expected to occur through collateral sale and the borrower is experiencing financial difficulty, entities are required to disclose the type of collateral by class of financing receivable and major security class. Qualitative reporting is required to describe the collateral and any significant changes to the collateral securing the asset.</td></tr>
<tr><td>Legacy U.S. GAAP and Other Related Guidance</td><td>Under current U.S. GAAP and other related guidance, collateral reporting is not required.</td></tr>
<tr><th colspan="2">OFF-BALANCE SHEET EXPOSURES</th></tr>
<tr><td>CECL Requirement</td><td>Requires a description of the accounting policies and methodology used to estimate liability for off-balance sheet credit exposures and related charges for those credit exposures.

The description must identify factors that influenced management’s judgment (for example, historical losses, losses and existing economic conditions, and reasonable and supportable forecasts) and a discussion of risk elements relevant to particular categories of financial instruments.

Off-balance sheet credit exposures refer to off-balance sheet loan commitments (unfunded commitments that are not unconditionally cancellable by the bank), standby letters of credit, financial guarantees to be accounted for as insurance or other similar instruments, except for the scope of ASC 815 (Derivatives and Hedging).</td></tr>
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Legacy U.S. GAAP and Other Related Guidance	Current U.S. GAAP Off-Balance Sheet Credit Exposure standards require the evaluation of the probability of draw on commitments and risks; however, there is no differentiation between funded and unfunded on the balance sheet. Allowance amounts are reported as "Other Liabilities." Additionally, current U.S. GAAP guidance requires MD&A disclosure of qualitative factors such as the nature/terms of the off-balance sheet assets, significant concentrations of credit risk, required collateral, and face and/or contract value.
ALLOWANCE FOR CREDIT LOSSES	
CECL Requirement	Requires reporting by portfolio segment and major security type to enable investors to understand management's methodology, current estimate of expected credit losses, and factors that caused the allowance to change over time. The disclosure requirements for each period include a description of: • How expected loss estimates are developed • Accounting policies and allowance methodology, plus discussion of factors influencing management's current estimate of ECL such as past event, current conditions, and notably, reasonable, and supportable forecasts about the future • Risk characteristics relevant to each portfolio segment • Changes in factors influencing management's estimated ECL and reason for changes • Changes to accounting policy and allowance methodology, including rationale and quantitative impact • Reasons for significant changes in write-offs • Discussion and rationale for the reversion method used for the period beyond the reasonable and supportable forecast period • Amount of significant purchases or sale of financial assets • Amount of significant sales of financial assets or reclassifications of loans held for sale
Legacy U.S. GAAP and Other Related Guidance	Current GAAP and other related guidance do not require presentation of net investments in leases and HTM securities, nor does it require establishing a loan loss allowance at initial acquisition of PCI assets.

Additionally, under CECL — specifically, ASC 326-20-5-13 — financial institutions are required to provide a rollforward presentation of the allowance for credit losses by portfolio segment and major security type, including net investments in leases and HTM securities. For each presentation, the following items are required:

- Beginning balance of ECL
- Current period provision for ECL
- Initial allowance for credit losses recognized on financial assets accounted for as Purchase Credit Deteriorated (PCD) assets (if applicable)
- Write-offs charged against the ECL

Current GAAP and related guidance do not require a rollforward presentation of allowance for credit losses.

Available for Sale Securities

Discussed in ASC 326-30-50, available for sale (AFS) securities disclosure requirements remain generally the same as under current guidance. AFS debt securities disclosures should clarify for users the inherent credit risk, management's estimate of credit losses and changes in credit losses. Following is a comparison of key topics under CECL versus legacy GAAP.

AFS DEBT SECURITIES IN UNREALIZED LOSS POSITIONS WITHOUT ALLOWANCE FOR CREDIT LOSSES	
CECL Requirement	By each major security type, an entity must disclose the aggregate fair value and amount of unrealized losses for all AFS assets, including those in scope for Subtopic 325-40 (Beneficial Interests in Securitized Financial Assets). The disaggregation within the disclosure should include those assets that have been in a continuous unrealized loss position for the last 12 months and those in a continuous loss position for more than 12 months. Additionally, an entity must disclose additional narrative information to facilitate understanding of the quantitative disclosures and other information considered in support of the rationale for concluding that an allowance for credit losses is unnecessary.
Legacy U.S. GAAP and Other Related Guidance	All assets with unrealized loss positions are reported.
ALLOWANCE FOR CREDIT LOSSES, INCLUDING ROLLFORWARD	
CECL Requirement	Requires disclosure, by major security type, of the methodology and significant inputs used to estimate the allowance, including performance indicators and other policy elements used to recognize write-offs of uncollectible AFS debt securities. Changes in the allowance amount may fluctuate due to changes in the estimate of expected future cash flows. The amount may be reported as a credit loss expense, reversal of credit loss expense or interest income. Additionally, similar to Financial Instruments Measured at Amortized Cost, a detailed rollforward presentation of allowance for credit losses disaggregated by major security type, including the initial allowance for credit losses for PCD assets, is required.
Legacy U.S. GAAP and Other Related Guidance	Under U.S. GAAP and other related guidance, credit loss impairment on AFS debt securities is a direct write-down, reducing amortized cost basis. A rollforward of credit loss recognized in net income is required.
PURCHASED CREDIT DETERIORATED (PCD) ASSETS	
CECL Requirement	If an entity has purchased assets with credit deterioration, it is required to provide a reconciliation of the difference between the purchase price and par value.
Legacy U.S. GAAP and Other Related Guidance	Current U.S. GAAP and other required guidance does not require allowance booking at the time of PCI acquisition; therefore, no allowance for credit loss reporting exists.

Our Perspective

Prior to adoption of CECL, it is key for institutions to provide key stakeholders such as investors, the board, auditors and regulators with sufficient information to understand the change to the reserve estimate as well as the methodology and assumptions utilized to calculate the reserve estimate, and to ensure that the process and results can stand up to external audit scrutiny. By effectively discussing CECL implementation progress in the financial statement disclosures prior to implementation, institutions can enable stakeholder understanding of the prospective CECL financial statement impact, particularly understanding the impact of the methodology change to CECL from the incurred loss approach versus actual underlying changes in credit risk.

Post adoption, CECL disclosure templates and required data need to be created and in place to meet the January 1, 2020, CECL effective date for first-wave (calendar year) SEC filers. The increased CECL disclosures requirements also create data, system, process and policy demands on numerous functions and departments to provide

the detailed disclosures related to ECL estimate methodology and assumptions, quantitative information and metrics, and policy.

An assessment of an institution's existing credit loss-related financial statement footnote disclosures and MD&A analysis compared to the requirements of CECL is imperative to identify superseded as well as required changes to disclosures, or new disclosures. As part of this assessment, institutions will need to inventory data points necessary to satisfy the disclosure requirements, inclusive of the qualitative comments required by CECL.

Additionally, changes to data warehouses or other repositories may be required so that vintage data is available for presentation. In conjunction with data-mapping assessments, institutions should assess the sufficiency of their current-state internal controls, as well as revisions required to ensure the accuracy, integrity and completeness of their credit-related data. A close working relationship, including information exchanges at critical milestone dates with the institution's external and internal auditors, is one of many keys to success.

How Protiviti Can Help

Protiviti's CECL team brings together professionals with deep experience in financial services, loss reserving, modeling, internal audit, IT and implementation to help your organization meet CECL implementation timelines.

We provide support across the CECL implementation lifecycle and can help your organization:

- Source and utilize data/create reporting.
- Perform CECL readiness and pre-implementation gap assessments across functional areas.
- Provide professional project management (PMO) resources.
- Develop, validate and document CECL quantitative models.
- Design and document a qualitative-factor framework and methodology.
- Prepare GAAP-compliant financial statements footnotes and MD&A disclosures.
- Assist with external audit readiness and facilitate the auditor/client liaison function.
- Design and document SOX processes and controls.
- Perform CECL internal audits and create internal audit plans.

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